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French Tax Authorities release draft guidelines for interest deduction limitations

On March 16, 2012, the French tax authorities publicly released draft guidelines on the new financial expense deductibility limitations (the "Carrez Amendment") adopted on December 21, 2011. The tax authorities have invited the business community to comment on the guidelines before they are finalized. Until then, taxpayers can rely on the draft guidelines.

The Carrez amendment

The Carrez amendment is a new mechanism that disallows interest deductions for qualifying participations acquired by a French company. Specifically, the amendment disallows interest deductions when the French company cannot demonstrate that:

(i) Decisions relating to the participations are effectively made by the acquiring company itself, or by a company established in France that "directly or indirectly" controls the acquiring company under the French Commercial Code, or by a company established in France that is "directly" controlled by the same company as the one controlling the French acquiring company under the French Commercial Code; and

(ii) When "control or influence" is actually exercised over the acquired company, that control or influence is effectively exercised by the acquiring company, or by a company established in France that "directly or indirectly" controls the acquiring company under the French Commercial Code, or by a company established in France that is "directly" controlled by the same company as the one controlling the French acquiring company.

According to the draft guidelines, the new limitation is designed to prevent aggressive debt structuring in France, particularly when debt is artificially incurred by French entities acquiring shares of companies located outside France. However, the current wording of the draft guidelines creates some uncertainty as to the measure's scope and its possible application to the acquisition of shares or interest in French entities.

Scope of the new limitation

The limitation applies to:

- French companies and other entities subject to French corporate income tax;
- French permanent establishments of foreign companies subject to corporate tax in France; and
- French partnerships to the extent their income is allocable to a French or Foreign partner subject to corporate tax.

The new provision specifically excludes the acquisition of shares in listed and non-listed real estate companies.

The draft guidelines also target share capital increases where a French company controlling the French purchaser of the shares is financed with debt and contributes cash to fund the acquisition to the purchaser.

Burden of proof

The draft guidelines confirm that taxpayers must satisfy a cumulative test to demonstrate that an “autonomous center of decision” exists in France:

- The decisions relating to these shares must be effectively made in France, and
- The control on or influence over the target must be effectively exercised from France.

The draft guidelines include both tests within a common concept known as the "autonomous center of decisions". In addition, the application of group governance rules does not jeopardize the existence of an autonomous center of decisions.

The taxpayer has the burden of proof for these tests, and it can be met by any means based on the facts and circumstances.

The draft guidelines provide examples for meeting the burden of proof. One example is an autonomous decision made in France to acquire the participations and the ability to use and dispose freely of such participations (e.g., pledges, loans, etc., subject to certain requirements).

However, a contractual arrangement that would restrict the participation owner's rights, such as a non-transferability agreement, would be considered a lack of autonomy, unless it results from the group's internal governance or from specific requirements imposed by the banks participating in the acquisition's financing.

The draft guidelines provide the following examples for evidence of effective and active participation in the acquisition's decision process:

- Documents relating to the functional, organizational, and hierarchical links with the subsidiary, such as organization charts; and
- Minutes of shareholders and board meetings showing the effective attendance of the representative body members of the acquiring company, the ability to appoint its managers, officers, or directors, or the ability to determine distributions.

As indicated above, the control or influence must be effectively exercised by the acquiring company, or by a company established in France that directly or indirectly controls the acquiring company under the French Commercial Code, or by a company established in France that is directly controlled by the same company as the one controlling the French acquiring company. Therefore, the requirement for French establishment applies only to the company exercising control and influence. Thus, for a sister company exercising the control and influence, the common parent of the two companies does not have to be established in France.

For acquisitions prior to January 1, 2012, the taxpayer must demonstrate that an autonomous center of decisions exists during the first financial year “after January 1, 2012”. This means financial year 2013 for calendar-year companies.

For acquisitions made on or after January 1, 2012, the taxpayer must demonstrate that an autonomous center of decisions exists during that financial year or another of the financial years covering the 12-month period following the shares acquisition.

The demonstration is required only for the above periods and not for the entire disallowance period provided by the Carrez amendment (eight years).

Financial expense amounts subject to disallowance

The amount of disallowed interest expense is determined annually and computed as follows:

$$\text{Fiscal year interest expense} \times \frac{\text{Acquisition price of the qualifying shareholdings}}{\text{Average fiscal year amount of debt of the acquiring company}}$$

The acquisition price is the one agreed by the parties as recorded in the purchaser's balance sheet, so it is not subject to variation, unlike the debt amount, which can vary annually.

Also, debt that can be allocated to a purpose other than the share acquisition is excluded from the above ratio. Similarly, interest relating to this segregated debt is excluded from the computation.

Pursuant to the draft guidelines, the disallowance of interest expense under the new rule would not give rise to deemed distributions qualification. Therefore, French withholding tax should not apply.

Disposal of the participation during the disallowance period

When the participation is disposed during the disallowance period, the draft guidelines provide that the company will not be subject to additional financial expense disallowance.

When there is a merger, spin-off, or similar transaction, the disallowance will remain applicable at the level of the new entity holding the participation.

Application with other rules

The draft guidelines indicate that the new Carrez limitation may apply concurrently with the French thin capitalization rules and the "Charasse" amendment (an interest deduction limitation applicable to related-party acquisitions of French entities in the context of a French fiscal unity). When these limitations apply concurrently, the overall disallowance cannot exceed the total amount of the company's financial expenses.

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